FULL COMMITTEE HEARING ON INCREASING INVESTMENT IN OUR NATION'S SMALL BUSINESSES

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FULL COMMITTEE HEARING ON INCREASING INVESTMENT IN OUR NATION'S SMALL BUSINESSES

THURSDAY, JUNE 21, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 2:04 p.m., inRoom 2360, Rayburn House Office Building, Hon. Nydia Velázquez [Chairwoman of the Committee] presiding.

Present: Representatives Velázquez, Shuler, Moore, Altmire, Clarke, and Chabot.

OPENING STATEMENT OF CHAIRWOMAN VELÁZQUEZ

ChairwomanVELÁZQUEZ. I am pleased to call this hearing to order. I want to thank all the witnesses for being here today. Today's hearing will examine the role of venture capital in growing and sustaining our Nation's small businesses. There can be little doubt that venture capital remains as important as ever to our Nation's small businesses. This is particularly true for a key segment of the business community, startup and early stage businesses. These businesses are the engines that generate new ideas and new products. Their contributions to our communities and economy are frequently new, invigorating and transformational. Venture capital represents the lifeblood for these businesses, and without this vital resource, many startup companies will not reach their full potential.

Yet, despite the obvious importance of venture capital, it remains extremely difficult for startup businesses to attract this investment. Over the last 5 years we have seen a steady movement of venture capital toward later-stage small businesses. Recent industry studies confirm this trend and show that funding dollars for early-stage firms declined 30 percent in the first quarter of 2007 to only $1.1 billion.

Today, private venture capital places a substantial focus on later-stage businesses that have an established capacity to generate investment returns immediately. While this focus makes sense for investors, it is leaving many startups without access to the equity capital they need to succeed. The result is less innovation, slower economic growth and fewer new jobs for our Nation's small businesses.

In order to fill these gaps, Congress created the Small Business Administration's investment programs. However, many of these

programs are falling short, for a wide range of reasons, of achieving their potential. Some lack support both organizationally and financially, while others do not have a clear purpose.

Today, we will be begin the process of reviewing these programs to better understand how we can address these problems. Foremost among the agency's investment programs is the Small Business Investment Company program which has a proven record of success. Together with private investment topping $12 billion, the initiative totals over $23 billion in financing resources dedicated to small businesses. It has led to the creation of over 228,000 jobs and has brought investment to virtually every State and across a wider range of industry than has been served by the traditional venture capital industry.

Despite its successes, more must be done to channel investment to our Nation's small companies.

In 2005 the SBA ceased licensing new investment firms in the Participating Securities SBIC program. This initiative was the only SBA program focused on providing equity financing to early-stage and startup businesses.

In the 1990s, SBICs made nearly 50 percent of their investments in startup small businesses; over the past few years, this number has dropped to less than 30 percent and continues to decline. This development has been mirrored by the lack of support for the New Markets Venture Capital program, a program dedicated to bringing investment to small businesses in low-income areas. Together, these developments have cast a pall of uncertainty over the SBA's remaining investment programs and have undermined confidence in the Administration's commitment to its investment mandate.

One way to increase the availability of early-stage capital is to draw on new investment strategies. In today's hearing we will hear about one such approach, angel investment, which holds a great deal of promise for helping our Nation's entrepreneurs. It is my hope that we can help foster increased angel investment in small businesses to fill the void for seed capital that has been created by the elimination of the Participating Securities program.

It is with this goal in mind that I am introducing legislation this morning to support increased angel investment. By doing so, we can make certain the small firms have the capital they need to grow stronger.

It is important that we are here today to consider the availability of venture capital for small firms. Without such investment there will be less risk-taking and less innovation in our economy.

As this country continues to rely on entrepreneurs to spur economic development and create jobs, the need for equity investment only continues to grow. I look forward to this hearing and I want to thank again all the witnesses for their testimony.

I now yield to the ranking member, Mr. Chabot, for his opening statement.

OPENING STATEMENT OF MR. CHABOT

Mr.CHABOT. Thank you very much, Madam Chair. Before I get into my opening statement, I would just like to recognize a young lady who is in the back of the room—back there.

Would you stand up?

Tyler Banks is a senior at the School for the Creative and Performing Arts in my district in Cincinnati, Ohio, and she is up here with the Congressional Youth Leadership Council's National Young Leaders Conference. She is an excellent student and I am sure that we haven't heard the last. She would like to make a career up here and perhaps some day be living right down the street at the White House.

ChairwomanVELÁZQUEZ. Welcome, welcome.

Mr.CHABOT. Thank you, Tyler.

I want to thank you, Madam Chair, for holding this hearing here this afternoon. It is an important hearing on programs designed to increase the equity investment in small businesses.

Small businesses may finance their operations through debt or equity. Debt's primary benefit is that the owners maintain control of the company, but that comes at the cost of increased cash flow out of the company to service the debt. Equity investment reduces cash needed, especially in the early years of a business, but comes at the cost of reduced control by the owners.

Federal assistance to small businesses has come in the form of both debt and equity. Debt programs available through Federal-private partnerships include the 7a guaranteed loan, the microloan, and Certified Development Company, or CDC, programs. Equity investment is available through the Small Business Investment Company and New Market Venture Capital programs.

The committee already has addressed necessary changes in the 7a and CDC programs. Last week, the committee held a hearing on the microloan program, and will be addressing legislation on that issue soon.

It is now time for the committee to turn its attention to the equity programs operated by the Small Business Administration. First and foremost, the committee needs to understand the nature of equity investment in small businesses; then the committee must consider the quality of existing programs that assist small businesses to obtain equity investments. Finally, if those programs are inadequate, the committee should consider changes to improve the efficacy of existing programs or eliminate them and create more cost-effective, new ones.

For example, if the committee finds that the largest equity investment in small businesses comes from the personal assets of the business owner, then Congress must adopt tax policies that ensure the business owner keeps those assets rather than returning them to the Treasury in the form of taxes.

On the other hand, if significant equity investment in small businesses derives from investment firms such as small business investment companies, the committee certainly needs to make sure that the program meets its objectives without placing undue risk on the public treasury.

The review of equity investment programs also must examine where investment is lacking. I know the chairwoman has been to my district and seen the need in certain areas to increase investment as a component of economic revitalization. I would like to work with all the members of the committee in finding appropriate, cost-effective incentives that will raise the amount of equity investment in areas that have sorely lacked such investment.

Finally, I would like to thank the chairwoman for examining the angel investment phenomenon. Although angel investors may be an appropriate savior for small business, it is difficult for many small business owners to find an angel investor. Congress may have the opportunity to reduce the cost of raising equity funds from angel investors by eliminating burdensome and multiplicative Federal and State legislation.

Again, I would like to thank the chairwoman for holding this hearing and look forward to the ideas offered by our distinguished panelists here this afternoon. And I yield the balance of my time.

ChairwomanVELÁZQUEZ. Thank you, Mr. Chabot.

Our first witness is Mr. Michael Hager. Mr. Hager is the Associate Administrator for Capital Access at the United States Small Business Administration. The Office of Capital Access manages the administration business loan programs and performs lender oversight functions at SBA.

Welcome, sir.

STATEMENT OF MICHAEL HAGER, ASSOCIATE ADMINISTRATOR FOR CAPITAL ACCESS, U.S. SMALL BUSINESS ADMINISTRATION

Mr.HAGER. Thank you very much. It is nice to be here, Madam Chair. I want to thank you for the opportunity to testify on the status of small business investment company programs at the SBA.

The past few years have been challenging for the SBIC programs. Performance in the participating security programs, as you have indicated, experienced significant financial challenges over the last several years. Current estimates continue to project likely losses of 2.4 billion on the more than 8.5 billion that we have guaranteed through fiscal year 2006. Again, 2.4 out of 8.5.

Since the end of fiscal year 2006, the Investment Division has taken significant steps and devoted the majority of the management time for the SBIC program to manage the risk of the remaining Participating Securities portfolio. I am happy to report that with these solid management steps and the improved economic conditions, the current portfolio of Participating Securities licensees has stabilized. While some additional losses are still predicted to occur, the majority of liquidations have been recorded.

In fact, distribution activity among Participating Securities licensees has been robust in the last 8 quarters and the SBA and bondholders received distributions of almost 1.5 billion. For example, in December, the SBA issued a revised policy that allows a capitally impaired SBIC to emerge from restricted operations to resume normal investment activities.

In the debenture program the SBA continues to see solid performance from the licensees and is now beginning to see renewed interest in the SBIC debenture product.

In 2006, the SBA guaranteed over 400 million in SBIC debentures, and we anticipate exceeding that level this year. In the debenture program the SBA has been focused on making capital available to small business in low- and moderate-income areas

more than ever in the past. Currently, almost 20 percent of debenture funding goes to LMI areas.

Additionally, in our reference to address underserved markets, the New Markets Venture Capital program continues to foster economic development in low-income areas. The program, based on the SBIC program, is unique in that the fund managers of the New Market Venture Capital companies receive grant funding about operational assistance to actual and potential portfolio companies to reduce the risk of investing in these nontraditional areas.

To date, we have made over $40 million in equity and investments in over 50 portfolio companies, creating over 400 new jobs and sustaining some 1,100 jobs. The New Market Venture Capital companies also provided over 10 million in no-cost operational assistance to over 170 actual or potential portfolio companies in their targeted geographic areas. While these initial results are promising, it would be too premature to judge the success at this early stage of investing period.

The Agency is working diligently to strengthen its relationship with the industry. We have reinstituted our quarterly meetings with industry leadership to address issues and concerns on an ongoing basis. The SBA is actively seeking industry input on making the SBIC program more attractive to both venture fund managers and investors.

We continue to believe that the debenture program can have a substantial positive impact on the communities where SBICs invest, and we want to ensure the program is positioned to its maximum potential.

Chairwoman Velázquez, the SBA has a long history with venture capital and still views venture investment as an important source of funding for the small business community. The problems we see now are mechanisms available for the SBA's involvement in venture capital efforts and balancing those needs with the need to protect the taxpayers' investment.

We look forward to working with you to address these issues. We thank you for the opportunity to testify before the committee today. We look forward to questions from the committee.

ChairwomanVELÁZQUEZ. Thank you, Mr. Hager.

[The statement of Mr. Hager may be found on page 33 of the Appendix.]

ChairwomanVELÁZQUEZ. Before I introduce our next witness, Dr. Lerner, I would recognize the gentlelady from Wisconsin, Ms. Moore, for an opening statement.

OPENING STATEMENT OF MS. MOORE

Ms.MOORE. Thank you so much, Madam Chair. I will try to be brief.

I really did enjoy the testimony of Mr. Hager, and I am glad to hear that he still thinks that venture capital is extremely important. No guts, no glory. You really do have to take risks in order to spur our economy along.

I just want to say to the Chair and the ranking member that I am so appreciative of your having this hearing today. You guys have had great stewardship over this committee. We hear time and

time again people talk about how aspiring entrepreneurs need access to capital in order to fulfill their goals and to stimulate the economy and to create new jobs, and it is important to keep those things forward in our mind and not try to always balance that off with, quote, unquote, ″protecting the taxpayers' dollars″ because I think that we are at a growth rate in our country where we have got to help our entrepreneurs, who create 97 percent all new jobs, our small businesses, and the taxpayers. We definitely need to be in the position to help grow our economy for their benefit.

So many small businesses located in low-income and urban areas and rural areas lack this venture capital because they don't have angel investors and they don't have the three Fs—family, friends and fools—to help them get into business. So it really is important for us to realize that it is our responsibility to help spur folks that are going to constitute the majority of our economy.

President Clinton was really aware of this when he unveiled the New Market Venture Capital program as part of the larger initiative to meet this unmet challenge. I have to give President Bush credit because he, in fact, did continue to authorize this program for the past 7 years, although he requested no money for this initiative. But it still is on the books, unlike the Participating Securities program, which is virtually shut down.

What are we going to do with urban and rural areas if we don't, as you know, Mr. Hager, try to figure out ways to make our products, our venture capital products really, really work? In the first—in 2006, three regions, Silicon Valley, New England, and Los Angeles accounted for approximately 60 percent of all venture capital dollars invested and 50 percent of all deals.

The reason I asked to make an opening statement is because I am a really big stakeholder in what we do here. My district of Milwaukee, that the New Market Venture Capital program has not yet had time or resources to reach, ranks 48th out of 50th of the largest U.S. cities in terms of venture capital dollars, and we are in the midst of the Rust Belt. We need help with venture capital.

So my question to you, Madam Chairperson, ranking member, what is the best way to get equity capital to underserved markets? And I believe we ought to look at funding the New Markets program in another round as a potential solution.

Just briefly, because I realize that my time is waning, we have invested more than $13.4 million in this patient capital in 29 companies. They have provided $6 million in operational assistance to 163 businesses and entrepreneurs, and they have created or maintained 1,500 jobs in low-income communities. The difference between this program and SBIC's is that New Market Venture Capital specifically targeted low-income communities.

To build on this initiative, I introduced the Securing Equity for Economic Development of Low-Income Areas, the SEED Act, which would reauthorize a New Market Venture Capital program. It would go further to incorporate small manufacturers into the mission of the program, something that was really important to our former chairman, Mr. Manzullo.

So, Madam Chair, with that, I would yield back. And I thank you all for your indulgence.

Chairwoman VELÁZQUEZ. Thank you, Ms. Moore.

I will ask any other member who wishes to open.

So I would like to introduce Dr. Josh Lerner. Mr. Lerner is the Jacob H. Schiff Professor of Investment Banking at Harvard Business School, with a joint appointment in the Finance and Entrepreneurial Management units. Dr. Lerner worked for several years on issues related to technological innovation and public policy at the Brookings Institution for a public-private task force in Chicago and on Capitol Hill before earning a Ph.D. From Harvard's Economics Department. Much of his research focuses on the structure and role of venture capital on private equity organizations.

Dr. Lerner, welcome. You will have 5 minutes to make your presentation. Thank you.

STATEMENT OF JOHN LERNER, JACOB H. SCHIFF PROFESSOR OF INVESTMENT BANKING, HARVARD BUSINESS SCHOOL

Mr. LERNER. Thank you very much for the introduction and the invitation to testify today as part of this review of the Small Business Administration's equity investment programs.

In my testimony today I will emphasize two points, first, that venture capital can play a powerful role in encouraging innovation and economic growth; and second, that it is natural to believe that government programs can boost venture capital. At the same time, however, these efforts must be carefully designed to work with and listen to the private venture capital market and its dictates and to embody thoughtful evaluation of the programs.

Financing of young firms is a challenging process. Young companies, particularly those in high technology industries, but also more generally, are often characterized by a considerable degree of uncertainty and substantial information gaps.

We have argued that specialized financial intermediaries such as venture capital organizations can address these information problems and these uncertainty problems. By intensively scrutinizing firms before they provide capital and then monitoring them afterwards, venture capitalists can alleviate the information gaps and reduce the capital constraints that several members of the committee have talked about in their opening statements.

Venture capital seems to play a very important role in our economy. While it is challenging to figure out exactly how much innovation is caused by venture capital, there have been a variety of studies which have tried to piece together this relationship.

After looking at a number of considerations, venture capital has a very strong positive impact on innovation. While the estimates vary somewhat with the techniques used, on average, a dollar of venture capital appears to be three to four times more powerful in stimulating innovation than a dollar of traditional corporate R&D. Since innovation is closely linked to economic growth, rising productivity and increased wages, venture capital is clearly playing a vitally important role.

At the same time, the impact of venture capital on innovation does not appear to be uniform. In many instances, the levels of venture capital an promising technologies may undershoot the desired levels. In these cases, promising companies may be unable to

get funding no matter how good their ideas. Moreover, as Congresswoman Moore pointed out, venture capital is highly geographically concentrated in a few regions in the country.

Given these patterns, it is natural to view government funding as a potential solution. The characteristics of a venture capital market lead there to be a natural government role in stimulating the evolution.

Venture capital is a business where there are increasing returns. Put another way, it is far easier being a venture capitalist if there are 10 other venture capitalists nearby than if one is the first one. It is in these types of settings where there are what economists call ″externalities″ that government can often play a very positive role.

At the same time, however, governments must avoid the common pitfalls that befall venture capital initiatives. One common failing is to ignore the realities of the venture capital process. For instance, many venture capital initiatives have been abandoned after a few years. The programs' authors have apparently not understood that these initiatives take many years to become successful. In other cases, they have added requirements that have proved to be counterproductive.

A closely related problem is the creation of programs that ignore the market's dictates. Far too often government officials have sought to encourage funding in industries or geographic regions where the private interest is simply not there. As a result, the result has been wasted resources.

Effective programs, such as the Yozma Program in Israel, address this problem by demanding that credible private sector players provide matching funds. Thus, when encouraging new venture funds under the New Markets program it will be important to ensure whether, through matching funds requirements or other means, that these new funds are fundamentally viable ones.

Finally, it is important to have careful evaluation, as well, as part of these fund, scrutinizing not only the companies, but also the venture groups themselves.

I want to thank you once again for this chance to testify.

ChairwomanVELÁZQUEZ. Thank you, Dr. Lerner. I think that we could do this in 5 minutes.

[The statement of Mr. Lerner may be found on page 38 of the Appendix.]

ChairwomanVELÁZQUEZ. Our next witness is Mr. May. Mr. May is the Chair of the Angel Capital Association, a peer organization of Angel Investing Groups in North America. Mr. May is also the managing partner of New Vantage Group, a Virginia firm that mobilizes private equity into early-stage companies and provides advisory services to both firms and private investors.

Mr. May's experience in private equity capital spans 15 years and ranges from venture capital fund management to angel investing.

Welcome, sir.

STATEMENT OF JOHN MAY, CHAIRMAN, ANGEL CAPITAL ASSOCIATION

Mr.MAY. Thank you very much. I could do this in 2 minutes, 2 hours or 2 days, but I appreciate the 5 minutes.

I really appreciate being able to represent the early-stage venture capital which is angel investors. I am part of a group that has just been formed over the last year called the Angel Capital Association, which just shows the maturation of the group of angel investors who try to pool their capital and be a more sophisticated resource to all 50 States.

We have grown to represent groups that have 10 or 12 investors, groups that have 270 investors. And there are about 5- or 6,000 high-net-worth individuals who belong to these groups.

But my experience has been that the U.S. is struggling with an absence of early-stage institutional venture capital. In our written testimony, we talk quite a bit about this lack of capital, and I really appreciate your attention at the committee level, Madam Chairwoman.

The institutional venture capital industry is only at about $260 billion and puts out about $25 billion a year. We estimate with the little bit of research that has been done on high-net-worth individuals, angels, that it is about the same size, about $25 billion. But we think we probably put it out in about 50,000 transactions, whereas last year the venture capital industry had about 3- or 4,000 transactions.

So there is an opportunity here if we can grow more high-net-worth individuals to play in this risky space; and to feel comfortable mentoring, that we have a chance to greatly leverage the institutional venture capital that is out there.

Let me just quickly read this quote that talks about who an angel is. They become an angel ″for a variety of reasons, including achievement of financial return,″ which is key, ″to support their community,″ which is also key, ″to create and grow companies, to find a new job, to learn new things, to make use of their expertise,″ and a very important sidebar, ″for personal enjoyment.″

So this is a giving back phenomenon, this is a patient capital phenomenon, and it is a mentoring phenomenon. It is the most valuable resource for the high-net-worth individual who invests in a stranger for long-term capital gain and to grow their regional economy. Ninety-eight percent of angel groups invest in their local economy—in Milwaukee, Golden Angels. All around the United States there are local groups that invest 1 hour drive time. They have to have some reward while they wait for financial return, which usually takes 3, 5, 7 and 9 years.

So let me just tell you where I think there could be help. This is a very touchy area, as Josh said, about how can nonprofits and government direct the for-profit, the individual, with their after-tax dollars to spend their time and money? I think we should study this some more, but the key to me is education, readiness programs, and awareness training.

The more we can help find ways to educate entrepreneurs what an angel or venture capitalist is looking for—because the most valuable resource we have is time, so if we waste time in the hunt between the two parties, it is really deadly—and how to educate

more angels. There are some programs out there I think we could support.

Also infrastructure and development of angel groups. There are a lot of States, such as Wisconsin, Ohio, Pennsylvania, that have found ways with six-figure investments to spread the word on how to educate angels, how to match the right entrepreneur with the right program—a very small amount of dollars to get a lot of bank for the buck.

There is a lot of discussion about a Federal tax credit program to enhance and to help. There is a lot of controversy over the success of the 19 or 20 State programs that have existed in the past. It is—just to note, the National Governors Association is about to publish a 20-State report on the effectiveness of State programs' funding, tax credit and so forth. So we would like to support dissemination of that study as soon as it is available in early July.

We definitely think leveraging private investors—and I would suggest we go beyond supporting the wonderful work of SBICs, which we have co-invested with and made money; and with the New Markets Fund, in which we have co-invested as angels with the one in College Park and made money, and we suggest you look at coinvestment or matching fund programs. Scotland has one, there are a number of States that have one.

If a group of angels or venture capitalists are willing to put their dollars at risk, that should be enough to trigger a matching amount from a leverage program. The UK has just instituted that program, and very successfully, to try to build on the experience.

So, as you know, I could go on. I am very enthusiastic about this. AngelAssociation.org, everything you wanted to know about angels in all 50 States. And thank you for this chance.

ChairwomanVELÁZQUEZ. Thank you, Mr. May. You will have an opportunity to expand when the members will have an opportunity to make questions.

[The statement of Mr. May may be found on page 44 of the Appendix.]

ChairwomanVELÁZQUEZ. So now the committee will stand in recess and we will resume right after the vote.

[Recess.]

ChairwomanVELÁZQUEZ. The hearing is called to order.

Our next witness is Mr. Stephen Vivian. Mr. Vivian is the Vice Chairman of the Board of Governors of the National Association of Small Business Investment Companies, the professional association for the small business investment company, SBIC, industry.

Mr. Vivian is also a partner with Chicago-based Prism Capital, Prism Opportunity Fund, one of only a handful of groups in the country managing both Participating Securities and debenture SBICs.

Mr. Vivian, welcome.

STATEMENT OF STEPHEN VIVIAN, VICE CHAIRMAN, BOARD OF GOVERNORS, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, AND PARTNER, PRISM CAPITAL

Mr.VIVIAN. Thank you. Thank you, Chairwoman Velázquez and Ranking Member Chabot for inviting me to testify and for all your hard work on the SBIC program over the years. I appreciate the opportunity to testify on behalf of NASBIC; it is something I am very passionate about, and also gives me the opportunity to apologize for record to Barry, whom I called Michael during the intermission.

Barry, I apologize for that.

As Chairwoman Velázquez mentioned, I am the incoming Chairman of NASBIC, and we represent the over 350 licensed SBICs across the country. As a brief background I just wanted to touch on the three different aspects of the SBIC program and give a little status update.

The debenture program, which is today the most thriving part of the SBIC program, has approximately 135 licensees and invests $5.8 billion in capital—or manages 5.8 billion in capital and invested about 1.2 billion in fiscal 2006. That program matches private capital raised by general partners, such as ourselves, with a two-to-one match from the government to invest, primarily debt, in small businesses. And the SBA sets the rate, the hurdle interest rate, that we put on and can maximize and charge the companies that we invest in.

The second component of the SBIC program consists of now only about 58 bank-owned SBICs, which have traditionally been non-leveraged, and since the passage of Graham-Leach-Bliley in 1999, most bank holding companies no longer invest through their SBIC licensees.

The third component, as the Chairwoman mentioned, was the Participating Securities program, which we do have a license for, which was started in 1994; and as Chairwoman Velázquez also mentioned, the SBA discontinued licensing new Participating Securities funds after fiscal 2004, really due to a couple of things—one, because of losses, and also because of a determination that the program no longer qualified for the Credit Reform Act.

Currently, the last of the SBA-guaranteed Participating Securities leverage will expire on September 30, 2008. There are currently 167 remaining Participating Securities funds. They manage about $11.5 billion of capital and invested about 1.5 billion in 2006.

After chairing the legislative committee a couple of years ago in attempts to revitalize the Participating Securities program, NASBIC took a different course this year and decided our mission for this year would be to try to work with the SBA and with the committees to rehabilitate the reputation of the SBIC programs that were remaining and thriving; and so, to that end, we proposed and supported the legislative initiatives that you all are considering to amend the SBIC program.

I just wanted to briefly go over the three things we talked about relative to the legislation that we support, because we do believe they help to improve the profile of the SBIC program with both investors that could invest in the program and with general partners that might want to run SBICs.

The first proposal is to increase the maximum amount that SBICs can invest in any single company. Today, that hurdle rate is low by market standards and artificially lowers the amount of investing that SBICs do into small businesses as general partners limit the amount of money and mete it out to the small businesses that they invest in. An increase in that overlying limit we believe would be very beneficial to funding small businesses by debenture SBICs.

The second proposal deals with the amount of capital under management by any single independent SBIC manager or multiple funds under management by SBIC fund managers; and we believe that increasing those rates which have been pegged and not increased enough, in our estimation, in recent years will help to promote further interest in the program over time and continue to drive managers to the program.

The third piece of the proposal is really the last shot that NASBIC has made in working with you all to try to solve a little bit of the pain for the remaining Participating Securities licensees that are left, and that is really a technical change to allow Participating Securities funds to draw leverage a little bit faster than they are currently able to draw leverage, in hopes that the leverage, which they have already paid for, will allow them access to slightly more leverage than they currently would able to get under the current legislative program.

So we really appreciate your support for the program over the years and your support for these legislative initiatives; and though they are technical in nature, we think they really are a step in the right direction to help keep promoting the debenture program and keep improving it so we can have it remain attractive for both small businesses and general partners.

ChairwomanVELÁZQUEZ. Thank you, Mr. Vivian.

[The statement of Mr. Vivian may be found on page 50 of the Appendix.]

ChairwomanVELÁZQUEZ. Mr. Hager, I would like to address my first question to you.

Can you tell us which of the SBA's existing programs help early-stage startup small businesses with investment capital?

Mr.HAGER. We have a number of instruments to use. I mean, arguably the debenture program would work. We are also, of course—

ChairwomanVELÁZQUEZ. What do you mean by ″arguably″?

Mr.HAGER. There could be some push-back to say it is not for startup, but clearly it has a 50-year history with all sorts of applications, including startup. Some that would push back to say ″no.″

ChairwomanVELÁZQUEZ. What other the programs?

Mr.HAGER. The New Market Venture Capital program that we have, it is still early—we are about 5 years into the program—but we also think that program would offer some startup. The startup has obviously dropped off, as you have indicated. However, the last couple of years it has been very stable, and we hope that it will maintain the current level that it is today.

ChairwomanVELÁZQUEZ. Let me ask you, how can a startup business with limited cash flow and a heavy need for capital investment benefit, how will that benefit?

Mr.HAGER. It would be—again, to go back, the debenture program has been here for 50 years, and it has historically been able to provide capital to startups.

ChairwomanVELÁZQUEZ. Let's take the debenture program. If you are using the debenture program to fill the gap left by eliminating Participating Securities, can you explain to us, then, why has your agency proposed to keep the program level flat?

Mr.HAGER. ″the program level flat″? Help me with that. Which program level are you talking about?

ChairwomanVELÁZQUEZ. The authorization of 3.5 million. Did you ask for that increase?

Mr.HAGER. No.

ChairwomanVELÁZQUEZ. How then can you fill the gap that exists?

Mr.HAGER. There will be some dropout from the participating program that won't be filled.

ChairwomanVELÁZQUEZ. So that shows the commitment of the administration.

Mr.HAGER. The commitment of the administration is as strong as every. We have a 50-year—

ChairwomanVELÁZQUEZ. The facts are there or?

Mr.HAGER. The participating program was a program we could not support for the future. Out of 8.5 billion, 2.4 billion has been lost. Another 300 to 700 million is forecast to be lost. It is a program that didn't have good balance as much as we want to reach out, as much as we want to help. The participating program is a program that clearly did not have good balance.

ChairwomanVELÁZQUEZ. Where are the forecasts when you talk about the losses?

Mr.HAGER. Our current forecasts in the SBA of the participating program, we are right now 2.4 billion that we know we are going to lose. We are looking at a commitment of another 2.1 billion roughly.

ChairwomanVELÁZQUEZ. You mentioned the $2.5 billion in losses. So I just want to ask you: Has your agency actually realized losses in the participating security program in the amount that you quote, or are those projected losses?

Mr.HAGER. Projected losses.

ChairwomanVELÁZQUEZ. Okay. So Mr. Hager, one of the biggest challenges that women-, veteran- and minority-owned small businesses have to overcome is the inaccessibility of investment capital in the conventional capital venture industry. What is the SBA doing to increase equity investment in women-, veteran- and minority-owned businesses?

Mr.HAGER. No. It wouldn't take a lot to look at the numbers to understand that there is a problem there. We don't deny that there is not a problem there.

ChairwomanVELÁZQUEZ. So, for the record, let me share with you and the people here, the numbers.

In fiscal year 2005, only 3.4 percent of all financing in the SBIC program that went to that were majority black owned. For women-owned businesses, the numbers were worse with those businesses receiving 2.37 percent of SBIC financing.

For Hispanic-owned businesses, the statistics were even worse with only 1.39 percent of SBIC financing. And veteran-owned small businesses faired the worst receiving only half of one percent of all SBIC financing.

So if this is the result of the SBA current efforts to help this group, wouldn't you agree that a lot more needs to be done?

Mr.HAGER. We agree that we have to do everything we can to enhance those numbers. You know, when you look at the number of—from 2002 through 2006, the number of businesses in women-minority-owned—that are women-minority-owned, was roughly 20 percent.

Those numbers, not necessarily where we would like them, but 20 percent is the number that was achieved for those years. We have a number of programs that we are looking at. We have a number of outreach programs that have been launched. We recently conducted a symposium at the agency that was focused on women and minorities.

ChairwomanVELÁZQUEZ. We got a problem. You know that; right? We have a problem. The administration has a problem with those numbers. You have to do better.

Mr.HAGER. We would like to see the numbers improve.

ChairwomanVELÁZQUEZ. So let us talk about the New Market Venture Capital Program.

As we all know, it was designed to increase investment in small businesses in low-income areas.

Do you feel, Mr. Hager, that this is a worthwhile goal for the SBI even if the program requires increased funding?

Mr.HAGER. We believe that the funding level for the program today is where it ought to be. It is a program that was developed roughly 5 years ago. It was implemented. We are tracking the progress. It is still in the harvest period, as we call it. We don't know yet until we get some more experience with the program. We do believe it offers hope for us. We do believe that there is a potential here to expand it.

But we don't want to artificially, prematurely make a recommendation on this program until we see the results.

ChairwomanVELÁZQUEZ. And so can you tell us, where is the funding level for the program? At what level?

Mr.HAGER. We have committed some $7 billion for this program; $40-some million has been, you know, committed, has been allocated. There is still a balance in the program. It is a new program, relatively new.

ChairwomanVELÁZQUEZ. When was the last time that it got funded?

Mr.HAGER. I think the year for that—

ChairwomanVELÁZQUEZ. I will help you, 2003.

Mr. Hager, the New Market Venture Capital was a manifestation of Congress's belief that small businesses in low-income areas need additional support in acquiring investment capital.

What has the agency done to fulfill this mission?

Mr.HAGER. We believe that we have, again, a number of venues to address that issue both on the venture side—I keep coming back to that. That program has served us well for 50 years. We maintain it is a strong program. We maintain there is a good balance be-

tween taxpayers and recipients of those funds. And we think it is a good approach.

We have a New Market Venture Capital Program that we talk about. That offers a lot of hope for the future based on, you know, the success of the program.

Chairwoman VELÁZQUEZ. Without money? Without the administration coming to ask for money?

Mr. HAGER. Until we see what happens with the program, we think we are where we ought to be right now.

Chairwoman VELÁZQUEZ. You talk a lot about the New Market Venture Capital Program a lot in your testimony, and then your agency—you are saying that the agency is truly committed to fostering development through this program. And I just cannot understand, if you come here and say and talk about how much this program can accomplish and how committed you are, and then your agency does not request—hasn't requested any more money for the program for the last 4 years, something is wrong with this picture, sir.

Mr. HAGER. We are passionate about what we do.

Chairwoman VELÁZQUEZ. I can see that.

Mr. HAGER. We are, and we work very hard at it. We don't want to propose additional funding on a program that is new, unproven. We don't want another participating security—participating program where we have to come back to say we have a problem here. Well, what kind of problem? $2.4 billion problem. We don't want—we don't want to—

Chairwoman VELÁZQUEZ. Sir, don't continue to say $2.4 billion when you answered to me my question about saying that those are estimates. You don't know the numbers.

Mr. HAGER. We can't guarantee it, but with great predictability, those are real numbers.

Chairwoman VELÁZQUEZ. I will now recognize Mr. Chabot.

Mr. CHABOT. Thank you, Madam Chair.

And, Mr. Hager, I will follow up with you if I can.

Could you tell us which outreach efforts are in place so that small business owners know more about possible angel investors?

Mr. HAGER. We have a whole host of outreach programs that we have launched in the last couple of years. It would include hosting work groups, brain storming meetings. We have done that in a number of major cities throughout the country. Holding frequent discussions with NAIC, 3 years in a row of supporting events cosponsored by NAIC, participating in speaking at the North American Alliance gathering.

I can go on and on, outreach programs that are underway, including a symposium that was conducted back in December of last year where we brought in industry leaders, academicians, people that would be able to assist us in how we can come up with new ideas in outreach.

We came up with a whole host of suggestions that are being evaluated right now. And we will continue these outreach programs.

Some of these suggestions will no doubt be implemented.

Mr. CHABOT. Thank you.

Dr. Lerner, if I could move to you next.

You had mentioned in your testimony that venture funds tend to sort of group together, and the first one is obviously tougher environment and kind of breaking ground, and it is easier if you have a group of them or if you are following. And you had also mentioned that there has to be interest in the private sector if it isn't—if the market isn't going to support it, no matter how much money you dump into something, it is just not going to ultimately work.

Could you expound upon that, both of those things, a little bit?

Mr.LERNER. What you are getting at is one of the fundamental challenges here. That, on the one hand, you know, we just have this natural desire to see venture capital and entrepreneurial activities taking place everywhere. And ideally that would be the way that would be sort of spread out, you know, very evenly and have activity taking place in all places.

Unfortunately, it seems that when governments have tried to do this, and there are examples ranging from, you know, from around the globe where they have said, let us just sort of try and encourage activity evenly so everyone is saying it just fundamentally doesn't work; this is an activity that seems to be concentrated and lumpy in its nature.

Now that, when you first state that, it doesn't sound very appealing. And in fact, when I have made statements like this, I have been criticized in all corners of the globe from Finland to China for having said something along those lines.

At the same time, though, I think there is hope. And it is not—we don't need to take this sort of Draconian view, and Silicon Valley and Massachusetts are venture capital; we can't do anything anywhere else. But I think it does make sense to say, rather than trying to duplicate Silicon Valley, rather than trying to create a little high-tech cluster in every region, we need to think very carefully about what are the strengths of each given region and what are the things where there is a real potential for private sector activity and real vibrancy.

To just simply throw money in the hopes of duplicating Silicon Valley is unlikely to be successful, but if we can figure out ways and places where the—where there is potential in getting the private sector involved in terms of providing matching funds, is an important way of doing it. We can duplicate features of the venture model in many different places around the Nation.

Mr.CHABOT. Mr. May, would you agree that an increase in the tax rate for long-term capital gains would be harmful to investors in two ways: It would reduce the return on angel investments, and it would reduce the funds that angels have to invest? And also, is the Angel Capital Association supportive of extending the President's tax cuts?

Mr.MAY. Thank you for the question.

No high-net-worth individual doing long-term capital gain patient investing in a high-risk environment would like to see a higher tax rate on those long-term capital gains. When I go around the world talking about, is the U.S. government sponsoring and supporting angel and venture activity in the United States, I say, no, except for 15 percent long-term capital gains tax rates as an encouragement to take the risk on that capital.

Because, in general, this has been a grassroots-up phenomenon, not a top-down like in the EU, the Angel Capital Association is so new, less than a year old, and just formulating how it should approach policy among what we call herding cats.

As you can imagine, we have angels from all walks of life and all jurisdictions. We have not yet taken a policy position on anything, but we are developing it. We would be glad to know what areas we should be responding to these kinds of questions.

But as a group, it is too new to have a stated policy like a trade association. You can imagine trying to deal with all of those different individuals and get a vote.

So it is neutral on it to date.

Mr.CHABOT. And, finally, Madam Chair, if I have time to ask Mr. Vivian a question.

Are there specific industry sectors or geographic areas that need more SBIC funding and cannot obtain it through the limited programs operated by the SBA?

Mr.VIVIAN. My opinion, the answer would clearly be, yes. If you go outside the regions that include Silicon Valley or Route 128 or Austin, Texas, there is a dearth of private equity. The statistics will show well over two-thirds of the dollars invested, and if you break it down by county, it is staggering how much venture capital is concentrated in a handful of counties.

So, clearly, there is a dearth of venture capital and private equity outside of those regions. And quite frankly, one of the very disappointing things to NASBIC, as it related to the Participating Securities programs, was we could debate whether the structure was right or wrong, but the intent and the spirit of the program—the program worked, and it drove capital. Our little firm in Chicago, and other people can say Chicago is full of private equity, but we write checks and in a range from $750,000 to $3 million in our equity fund, and that money does not exist.

So, clearly, there is a need, and I think one of the things that Josh mentioned I would also echo. If there are legislative initiatives around programs, there needs to be a long-term horizon and a vision to keep those around.

One of the problems that the Participating Securities program was rolled into along with the rest of the venture industry was they ramped the commitments into the teeth of the recession and the economic bubble and the dot-com bubble. Everybody lost money during that period. Not just the SBA. I would argue that SBICs performed as well or better than the vintage year funds that the rest of the private equity industry put forth during those years, but you have to have a duration and a perspective and a willingness which is why maybe do tweaks to a program so that it won't result in a backlash if there are losses, because if you are screwing around in private equity, there are going to be losses. That is just the nature of the beast.

Mr.CHABOT. Thank you very much. I yield back.

ChairwomanVELÁZQUEZ. Ms. Clarke.

Ms.CLARKE. Thank you very much.

It is really disheartening to hear today that many of the Small Business Administration's programs being discussed are being eliminated from the Federal budget.

The administration must continue to fund these initiatives in order for these programs to thrive and to flourish and, you know, to hear that the 50-year track record that you have is what you used to sort of substantiate success, it just doesn't jive when we see so many businesses out there in need of our support.

It is really an imperative, and I hope that you will really reassess that and do some, what I believe, is some really in-depth analysis. We have got so many businesses out there that really need the help and the support at the same time that we are cutting funds, it just seems counter-intuitive.

The SBA was created to aid and counsel and assist and protect small business concerns.

As you already know, small businesses remain a critical component of our economy in the 21st century, and your administration must do all it can to make sure that women and minority-owned businesses start, build and grow in the years to come.

I would like to ask Mr. Hager.

It has been recently reported that SBA plans to reduce fees for small business investment companies which use the government-backed loans to make venture capital investments, and according to the administration, these fee cuts will allow small businesses to avail themselves to the SBIC program more than they did last year.

The SBA, however, also has ceased issuing new leverage commitments to many entrepreneurs due to your administration's decision to move to the program to a zero subsidy, thus making it virtually insolvent.

Why has the SBA continued to pursue a zero-subsidy policy in the fiscal year 2008 budget which negatively impacts on minority entrepreneurs in receiving capital investments?

Mr.HAGER. The whole issue of zero subsidy is not only in the capital markets group, but it is also in the loan area.

We strive, we work very hard at achieving zero subsidy to eliminate the requirement to come forth and have various costs created and covered by budgeting from Congress every year.

Many times the budget doesn't get approved on time. We then have to cease programs.

We, by far, would rather see a program that is zero subsidy, is paying for itself because we have proven time and time again that, in the long run, we believe the programs are far healthier; we don't expose ourselves to interrupted capital; and we believe the end result—

Ms.CLARKE. With all due respect, if that is what you would like to see, why hasn't a real viable option been proposed by SBA? To just stop it and not present a viable alternative doesn't help the people of our communities, the entrepreneurs of our communities. I am sure there is a lot of brilliance and intellect over there at the SBA. With a little bit of imagination and with all of the gentlemen sitting with you here today, it shouldn't take coming before us to realize that, if you stop this, it is going to have an adverse impact somewhere.

And it would seem to me that, before we make these type of Draconian moves, we would, you know, consult with those and say, look, you know, this is not the type of cost that we want to absorb

any longer, but we know that there are folks that rely on this out there.

What can you come up with that we can present to these communities, to the people of the United States, that will substitute for what we will have to phase out?

Isn't there anyone thinking at that level at the SBA currently?

Mr.HAGER. We think about it a lot.

Ms.CLARKE. Okay. You answered that question. I am glad you think about it a lot.

Mr.HAGER. Thank you very much.

Ms.CLARKE. Where are we in proposing what the next steps are going to be?

Mr.HAGER. For example, the New Market Venture Capital program is new. It is 5-years old. And by the way, that program is well funded. If first payment doesn't occur, repayment for 5 years after the conception of the program. So that funding will go out covering us for the next couple of years without a problem at all.

The participating program is the one that we have indicated we do not support it going forward. Why? We did not have a good balance between the user of that program and the taxpayer. The projected losses for that program that we have absolute certainty will occur are Draconian. I mean, it is not fair, in our opinion, to the taxpayer to be making that up.

Therefore, we have ceased supporting that program with annual funds, and we have also indicated that, if we were to apply fees to cover the expense of that program, nobody would participate.

Ms.CLARKE. But, Mr. Hager, I understand what you are saying. At the same time, the alternative, if it is the New Market Venture Capital program, which made over 40 million in equity investments and over 50 portfolio companies creating 400 new jobs, you claim that it is premature to judge the overall effectiveness of the program in your written testimony.

These numbers seem very impressive. Don't you think that additional funding would not only bring new companies into the program there by increasing equity financing to entrepreneurs in low-income areas but also increase the companies' success rate.

Mr.HAGER. I totally understand where you are coming from.

Where we are coming from on the assessment of the program, the first payments aren't due in for up to another year. And until we start seeing what actually happens on the repayment, we can't say we need more money to expand this program. It is in a—we want to see what the—

Ms.CLARKE. Is this like a pilot that you are running here that says that, you know, we are going to have a control group, and until that control group is manifested, we are going to hold back on what we know is a need in the United States of America; is that where we are at this stage?

Mr.HAGER. It was not set up that way.

Ms.CLARKE. I didn't think so.

So that is why I am a bit concerned about, you know, the way that we are going about this. That is because business does not operate in a static environment like that. It doesn't thrive in a static environment like that. And certainly our communities, you know,

deserve better than that. And so if we are going to set up these control groups situation, which is in effect what we are doing—

ChairwomanVELÁZQUEZ. Would the gentlelady yield to me for a second?

Ms.CLARKE. Okay.

ChairwomanVELÁZQUEZ. Mr. Vivian, I would like to askyou, if this is the way you invest, you invest and then you wait for 6, 7 years?

Mr.VIVIAN. No.

ChairwomanVELÁZQUEZ. You have one more minute.

Ms.CLARKE. I think the point has really been made.

I am just disappointed. I am a new Member here. And, you know, I have been just dumbfounded, quite frankly, by the way that we are not looking at using the best of our talent, skill and ability to do what needs to be done to assist in our communities and the SBA. So many people are looking to you for your help and your guidance and your support. If in fact you feel that there is a danger to the taxpayers' money, I think it is also your obligation to look at other alternatives that can be created.

Like I said, the talent expertise is sitting right next to you there. These are folks you can draw on and say, listen, right now this fund looks like, you know, it is going to be a pain in the butt for all of us for the future, for the foreseeable future, what can you suggest that we can do as a product that we can get it to these communities immediately as an alternative to assist those entrepreneurs?

I just don't hear that coming forth, and I hope that that—ultimately, that is what I will be looking at.

Mr.HAGER. But I hear you loud and clear, and to show you an example, on a quarterly basis, we meet with the trade group to say—we address a whole host of issues. But certainly as we talk about product phase-out, you know, what can we do? What are the options going forward? You know, certainly the New Market program is one. Certainly we need to take a look at a program that just started in 2001. What kind of risk are we exposed to, to make sure that we have a good balance between, again, the recipient of the dollars, the capital and the taxpayer?

ChairwomanVELÁZQUEZ. Time has expired.

Ms.CLARKE. Thank you very much, Madam Chair.

ChairwomanVELÁZQUEZ. Dr. Lerner, one of the shortcomings you mentioned in the government investment program has been a high emphasis on early results and a tendency to terminate these programs prematurely had those results not been achieved.

So in the case of patient equity investment, what time frame should we expect before a program begins to bear fruit?

Mr.LERNER. I think it is an excellent question, and we can point to many examples where programs have been killed too soon. I think a great example is France, where it seems every time a new president has been elected, they announce a new entrepreneur program. And then, 2 years later, they say France doesn't have an entrepreneurship, so let us get rid of the program.

But clearly doing evaluation is important in understanding what is going on. But it is simply the process of growing—when you think about creating a new venture industry, particularly in an

area where it hasn't been there beforehand—is going to take a while for this to happen. You are not just creating companies, you are creating a whole system in terms of not only the financiers but the lawyers to help them with the process, the accountants who understand working with these firms and so forth.

So I do think that to think about this as something that can be done in a couple of years is, you know, probably naive; that we are talking about more like the length of a decade or even longer. It is obviously challenging in the sense that, in the position of a steward for public funds, one doesn't want to waste money or throw good money after bad. But at the same time, you have to realize that even if we look at some of the, you know, very successful programs that have been very—that have been out there, such as the original SBIC program, the first 10 years of it were not a great success. In fact, there were numerous hearings where Congressmen sitting in this very room berated people for having set up the program in the first place.

So one really needs to think about it in the time frame of a decade or longer rather than a couple of years.

ChairwomanVELÁZQUEZ. In your testimony, Mr. May, you say that government leverage, if appropriately structured, could play a role in increasing angel investment in small businesses. How should this leverage be structured and what should be avoided if the SBA's involvement in angel investing is to be successful?

Mr.MAY. That is a great question we are struggling with. And as we do that, I am going to keep you all informed.

The only thing that I have seen as a new initiative that I think has some merit that I have seen in other countries is a matching approach as opposed to a an entirely new bureaucracy or a new attempt at raising capital.

And the State of Ohio, for example, has a wonderful program that the Ohio Tech Angels have one-third of a side car fund from Nationwide Insurance, one-third from the Ohio State University and one-third from the State of Ohio, putting its funds on a dollar-by-dollar basis side by side with risk capital directed solely by private angel investors.

So I guess what I am saying is the kind of discussion that we are going to have over time now that, you know, we are taking a little bit more public role, would be to explore some of these creative things being done at the State and local level and see if they were used at the national level, whether it be underserved markets or national, whether that has some fruit as opposed to a new bureaucracy.

ChairwomanVELÁZQUEZ. Dr. Lerner, you mentioned that a common failing in government investment programs is a tendency to focus on unrealistic metrics to measure the program's success.

How should an investment program's success be measured?

Mr.LERNER. I think it is a great question.

I mean, clearly, at the end of the day, one thing that you do want to look at is financial return. Now it is important, as we talked about before, to look not look just simply at absolute return but at return relative to what other funds in the market are doing.

But I think it is also clear that, if we are spending public money, it is not simply because of financial return.

We have a much broader set of social goals as well. And these include things where it is alluded to earlier in terms of employment creation, in terms of creating, you know, creating an environment where it is easier for the next generation, for entrepreneurs and so forth.

And certainly when we have—when I have been in a situation advising governments about undertaking evaluations of programs, what we have tried to push for is both a quantitative and a qualitative side and saying, let us not just look at things that can be easily measured, but let us also look at the broader kind of investments. And, of course, those make us a little nervous because it is hard to necessarily quantify all of that stuff.

But it is important to take that broader view and to get a sense of success and failure.

Mr.MAY. I just wanted to mention, I really do think a way to get at some of the current data would be this study that I know is about to come out from the National Governors' Association recommending to the Governors what they have found at their Center for Competitiveness has been the experience of different tax credits systems at the State level, funding, seed level. Our comments are due back to them at the end of June. So as early as July, I would hope that the staff and the SBA avail themselves of that recent research.

ChairwomanVELÁZQUEZ. Mr. Vivian, you heard me when I was asking Mr. Hager, in terms of the numbers regarding the SBIC success, the program continues to have difficulty in providing investment to small businesses that are majority owned by women, minorities or veterans.

What more can be done to increase investment in this group?

Mr.VIVIAN. I think—there is no simple answer to that question. The challenge always comes back to, when we have been asked that question as either an association or as investment professionals, we have never turned a business down based on the gender or nationality of the entrepreneur. We look at the merits of the business.

And I think the challenge that SBA has is the programs that have been called in the past directed or targeted programs have never really caught fire, for whatever reason. I don't know the answer to that question as to why the more directed programs have not received as much interest among the investment community or investors.

And, you know, I don't have a great answer to that question, Chairman. I wish I did. I do know that, in the broader limited partner community, which is the pension funds and endowments and foundations that are really the drivers of investment into private equity and capital communities, there is a major focus now on what they are calling double bottom line investing where they get both financial return and social return for what they do.

And I think the leadership within the investment community and discussion and education and leadership by SBA in those initiatives, I believe, is starting to make a difference. And, you know, the proxy that I use is the number of women and minority general partners that I see and that we see at conferences, in fact, there was a conference held in New York about a week ago on minority-

and women-owned venture capital and private equity firms and investing in those firms.

I believe there is a building wave of interest amongst the financial community to recognize that there is a problem there. And there is—something needs to be done, and it needs to probably be a collective effort on a public-private partnership to figure out how to solve those problems.

ChairwomanVELÁZQUEZ. Thank you.

Mr. Chabot.

Mr.CHABOT. Thank you.

Dr. Lerner, does the amount of Federal and State regulations impede the capacity of small businesses to obtain equity financing? And do you think that Congress should take any action to eliminate the duplicative regulation of securities markets by Federal and State regulators, and would such an action improve the capability of small business owners to obtain such capital?

Mr.LERNER. What you are raising is a set of really important issues.

Clearly we have seen, you know, a decline in terms of the share of, for instance, initial public offerings taking place in the United States on a worldwide basis, a pretty dramatic pattern over the last 5 years.

Now part of that probably just simply reflects the growth of entrepreneurship in markets like India and China and more recently in Europe and probably was inevitable. But it is hard not to feel that the failure of companies to go public and access the public markets here reflects a combination of regulatory constraints, some of which are associated with Sarbanes-Oxley, but others which aren't; fear of litigation and particularly the proliferation of, you know, the continued role of shareholder litigation against young companies and simply more structural changes in terms of the investment banking industry where there has simply been less time and resources for analysts to cover young growing companies.

All of these factors have combined to make going public less attractive, and this has also made it much more difficult for companies to get earlier stages of financing because you don't have the promise of ultimately being able to go public.

So I think that regulatory issues are part of the story, but I don't think they are all the story. And certainly there is a variety—it is probably one of a number of things that fits into this which is the brew of what is going on.

Mr.CHABOT. Let me follow up with something that is totally unrelated to that.

Do you think it makes sense that the vast majority of small business owners start their business using credit card debt, and if it doesn't make economic sense, that it really kind of shows a market failure in small business financing that it forces a lot of owners to finance the start-up of their businesses using such expensive credit card debt which is obviously much higher than one would hope that you start a business at.

Mr.HAGER. It is an important issue. I mean, clearly, when you are at that stage of starting a young company, except for the very fortunate few, most of whom have already been entrepreneurs and

been successful and made money for their investors, except for that group, it is very hard to raise money.

You have to just somehow get on the playing field any way you can and sort of bring that idea along to the point where you can—where you can sort of have the—have something to really show to potential investors, like angels.

And I think here, again, we can think about, you know, some of two difficulties particularly that minority investors face in the sense that the challenges of being able to access traditional capital markets in these instances often are going to be greater due to a lack of information or simply outright discrimination.

So I think it is clearly, this is a very expensive—credit cards are a very expensive form of financing. And you can think about many examples of entrepreneurs who ran up huge amounts of credit card debt and had very difficult situations.

But I don't think there is an easy solution or an easy way to get around this. Simply because that initial phase, it is so tough to raise money because you really have nothing but a dream to convince people to give you funding.

Mr.VIVIAN. Just to echo a little bit.

I think there are some endemic challenges in growing small business. I don't think it is a problem. The beauty of being an entrepreneur, you believe passionately in what you are doing and you don't care if anybody else believes in what you are doing. And the challenge is endemic to the private equity community; even if there were an abundance of seed capital, there are a lot of businesses that just aren't good venture capital investments.

The investments that we need to make into venture funds to drive returns that allow us to stay in business don't align with the vast majority of the companies and small businesses that get started.

Equity investing of the professional kind is driven at high-risk, high-return, and a lot of businesses—it doesn't mean they are not fine businesses that create jobs and add a lot of value to our country, but they are just not good venture capital investments just by the nature of the fact that they are unlikely to make someone 5 to 10 to 15 times their invested capital on a return basis in a short period of time.

ChairwomanVELÁZQUEZ. Ms. Clarke.

Ms.CLARKE. Thank you very much, Madam Chair.

I wanted to ask Mr. May.

Angel investments have accounted for more than 51,000 entrepreneurial investments a year and are rapidly becoming a way for investments to obtain early seed capital. The need for the early stage start-up capital for small businesses is being unmet by the SBA's existing investment programs, Particularly since the elimination of the funding for the SBIC securities program.

Angel investments have been great for job growth, mainly in the health care services industry. But individual investors tend to focus more on profits and not on community growth.

How can Congress make angel investing a more probable choice in many communities since it could help improve the economy?

Mr.MAY. I am not sure I have the answer to that. I am not sure that there is a one-stop-shop way to do that. But it is true that it

is so clear that there is this widening gap of institutional funding that is not available for high-growth companies, and that is really what we are talking about is the tip of the iceberg of these high-growth entrepreneurs that can never get funding from any of us.

But, yeah, it has gotten where there is less than a thousand transactions a year by the mainstream institutional venture capitalists in the same space that, as you say, there are 40,000 or 50,000 from angels and angel groups.

The problem is trying to force an individual to take the risk through any kind of government program is tough. I think what is needed, and we are looking at, is upstream. What we are doing is getting them to a stage that we need, if they are successful, to hand them off to somebody else who will provide follow-on financing.

The New Market Growth Fund we have co-invested with, and I think from the one example I have had here, is a successful program and might well merit expansion because when we need to find a $2 million investment after our $600,000 investment, if those kind of sources are available, that is good for the economy. And, again, whether it should be government-backed or whether there should be CRA credits or whatever it is, I think you are more likely to have the ability to help move the SBIC money than you will ever be able to push the angel money.

But we are trying, and we will continue the dialogue.

Ms. CLARKE. Mr. Vivian, I wanted to ask you, NASBIC, you heard some of the conversation I had with Mr. Hager. And there has to be some, you know, unconventional thinking going on right now given what we know is going to be a real hardship in the market of trying to fund start-ups and assist entrepreneurs.

Are there any legislative proposals that Congress should consider in order to improve the current SBIC program that you have given consideration to?

Mr. VIVIAN. I think that is an excellent question.

NASBIC worked for over a year, and I chaired the legislative committee when we tried to restructure the Participating Securities program. And, you know, there were arguably flaws in the way that program was structured. It didn't mean it didn't work. And this is your world. It is not a world I understand. But in this political climate, it did not appear that there was a lot of broad support to push that initiative through.

Would the initiative have kept the program alive and arguably kept licensing and kept seed and early-stage capital going? I believe, as a practitioner, because we did it, yes. So if there is something to consider for the future, perhaps it is a structural change to a program that, in my opinion, worked. And it worked well, and it drove a lot of capital to small businesses that needed it.

Just a real quick aside on your question to John as it relates to, what can the government do for angels?

The other place to look is something like tax breaks because these angels are wealthy individuals, and if they are looking to— if you want to spur their investment in a certain area, if give them a break for investing however you codify that to invest in seed and early-stage companies or seed and early-stage funds or funds of a specific size, you can incent people to take the risk.

I am not sure matching dollars incents a wealthy individual to take a risk in backing an entrepreneur.

If you juice their return, that might be a way to do it.

ChairwomanVELÁZQUEZ. I would like to add to your question to him, that is part of the angel investment legislation that I introduced today. And hopefully, Ways and Means will consider.

Ms.CLARKE. I am finished.

ChairwomanVELÁZQUEZ. Mr. May, I would like to ask another question.

You talk of a need for education on line infrastructure and other frameworks to support angel groups and develop angel networks. This is this type of support needed at the Federal level?

Mr.MAY. I am not sure—I know for sure it is needed at the local and the State level. I don't know, and I would have to look at your legislation and talk to you and your staff as to what mechanism you think administratively this legislation would penetrate to get to us, but what I know is that communities that have had successful educational seminars and other activities have then tended to get more activity. What I am amazed about in the United States is that there are 4 to 6 million millionaires; there are only 250,000 to 300,000 practicing angels by any of the research that we have done, about 5 percent. And there are only 5 percent of those that are practicing in groups that have a Web site, that meet monthly. So it is not as if everybody is doing it.

So we need a lot of help, and we are working on this personally. The academics are helping us with some of the research, but maybe there is something we can do together because there are a lot of people that have the capacity; they have the will.

ChairwomanVELÁZQUEZ. Would you like to add, Dr. Lerner?

Mr.LERNER. I think there is a need for a great deal of education on both sides. I think that this certainly is one of the barriers, is that I frequently will encounter people who are very enthusiastic and very passionate about their entrepreneurship dream, which is great, but in many senses, there are a lot of landmines along the road to entrepreneurial success.

And, you know, while certainly some things you have to learn by doing, there are other things that can be taught and sort of understanding, you know, how you go about the process of structuring a deal or how you look at people who are potentially giving money and trying to figure out whether they are serious or not. There is a lot that could be done.

And, again, I am not sure what the right level or the right place is for it, but I think it could certainly very much boost the entrepreneur success rate.

There have been a lot of academic studies that suggest that one of the main barriers to minority entrepreneurship has been the fact that people didn't grow up in families where a father or a mother were an entrepreneur already, and somehow it seems that when you grow up in that sort of family environment, you absorb a lot of these lessons, sort of, you know, sort of automatically. And it seems that education can play a really important role in overcoming some of the gaps and trying to make people in a position to be more effective entrepreneurs.

ChairwomanVELÁZQUEZ. Mr. May, why does angel investing have the capacity to generate investment in regions where there are not currently large numbers of venture capitalists?

Mr.MAY. The statistics about where professional investors are located, are just staggering. The National Association of Seed Venture Funds found that 26 States had zero or only one venture capital investment in their State last year; 77 percent of institutional venture capital over the last 10 years went to 23 States.

So it is true, you can't force the money in there. But it is true that, if we could find ways through the angel programs and through maybe some of these educational programs—I am finding that in Lexington, Kentucky; Kalamazoo, Michigan; Milwaukee—there is a lot of interest in keeping their people home, transfer from their universities. A lot of people are realizing, not everybody can go to Silicon Valley and Boston.

So one of our efforts is try to have a lot of educational seminars and work in helping people to understand how to do it in their backyard and not to feel inferior because they are not at MIT.

ChairwomanVELÁZQUEZ. Dr. Lerner, you spoke about the program in Israel as an example of a successful government venture capital program.

Could you talk about—could this program be duplicated in the United States, and if so, what characteristics of this program were most important to its success?

Mr.LERNER. Well, I think that, in many senses, it does provide a model that we could think about for trying to encourage venture activity in a variety of regions as well as in a variety of industries which are under-served. And in particular, the crucial elements were, first, that it relied on matching funds, so there was no amount of having to get funds from the outside. But they also structured in a way that made it very attractive, which is that not only did the government put in some money, a dollar to match the private money, but they then limited how much money the government could make as a return.

So they had this feature where the government's stake could be bought out once you got to a return of somewhere around 15 percent.

So, in other words, if you had a big winner. You would just simply go and buy out the government's half of it. The government would make a nice return, which is, you will get us money back for 15 percent.

But the view of the people in the Israeli government was saying we are going to win in any case. If we get successful companies, these are people who are going to be employing people, who are going to be paying taxes and many other things. We don't need to make sure that we get some huge—

ChairwomanVELÁZQUEZ. That is the type of mentality that is lacking sometimes in our government.

Mr.LERNER. Certainly the idea of having multiple metrics and looking at having broader social returns is an important aspect.

ChairwomanVELÁZQUEZ. Any members of the panel would like to add anything else?

Mr.VIVIAN. That sounds an awful lot like the Participating Securities program.

Chairwoman VELÁZQUEZ. Exactly.

Well, here we are.

It has been quite an insightful and very interesting hearing. Definitely we are going to move forward with legislation that will try to address some of the concerns that have been raised here this morning.

So members have 5 legislative days to enter a statement or other materials into the hearing record.

And with that, the hearing is adjourned.

Thank you.

[Whereupon, at 4:25 p.m., the committee was adjourned.]

STATEMENT
of the
Honorable Nydia M. Velàzquez, Chair
House Committee on Small Business
Hearing on the Status of the Small Business Administration's Investment Programs

I am pleased to call this hearing to order.

Thank you all for being here today. Today's hearing will examine the role of venture capital in growing and sustaining our nation's small businesses.

There can be little doubt that venture capital remains as important as ever to our nation's small businesses. This is particularly true for a key segment of the business community – startup and early stage businesses. These businesses are the engines that generate new ideas and new products. Their contributions to our communities and economy are frequently new, invigorating, and transformational. Venture capital represents the lifeblood for these businesses, and without this vital resource, many startup companies will not reach their full potential.
Yet, despite the obvious importance of venture capital, it remains extremely difficult for startup businesses to attract this investment. Over the last five years, we have seen a steady movement of venture capital toward later stage small businesses. Recent industry studies confirm this trend and show that funding dollars for early stage firms declined 30 percent in the first quarter of 2007 to only $1.1 billion.

Today, private venture capital places a substantial focus on later stage businesses that have an established capacity to generate investment returns immediately. While this focus makes sense for investors, it is leaving many startups without access to the equity capital they need to succeed. The result is less innovation, slower economic growth, and fewer new jobs from our nation's small businesses.

In order to fill these gaps, Congress created the Small Business Administration's investment programs. However, many of these programs are falling short – for a wide range of reasons – of achieving their potential. Some lack support – both organizationally and financially, while others do not have a clear purpose. Today, we will begin the process of reviewing these programs to better understand how we can address these problems

Foremost among the agency's investment programs is the Small Business Investment Company program – which has a proven record of success. Together with private investment topping $12 billion, the initiative totals over $23 billion in financing resources dedicated to small businesses. It has led to the creation of over 228,000 jobs and has brought investment to virtually every state and across a wider range of industries than has been served by the traditional venture capital industry.

Despite its successes, more must be done to channel investment to our nation's small companies. In 2005, the SBA ceased licensing new investment firms in the Participating Securities SBIC program. This initiative was the only SBA program focused on providing equity financing to early-stage and startup businesses. In the 1990's, SBICs made nearly 50 percent of their investments in start-up small businesses. Over the past few years, this number has dropped to less than 30 percent and continues to decline.

This development has been mirrored by the lack of support for the New Markets Venture Capital program, a program dedicated to bringing investment to small businesses in low income areas. Together, these developments have cast a pall of uncertainty over the SBA's remaining investment programs and have undermined confidence in the Administration's commitment to its investment mandate.

One way to increase the availability of early stage capital is to draw on new investment strategies. In today's hearing, we will hear about one such approach – Angel Investment – which holds a great deal of promise for helping our nation's entrepreneurs. It is my hope that we can help foster increased Angel Investment in small businesses to fill the void for seed capital that has been created by the elimination of the Participating Securities program. It is with this goal in mind, that I am introducing legislation this morning to spur increased angel investment. By doing so, we can make certain that small firms have the capital they need to grow stronger.

It is important that we are here today to consider the availability of venture capital for small firms. Without such investment, there would be less risk-taking and less innovation in our economy. As this country continues to rely on entrepreneurs to spur economic development and create jobs, the need for equity investment will only continue to grow. I look forward to this hearing and want to thank all of the witnesses for their testimony.

I now yield to Ranking Member Chabot for his opening statement.

Opening Statement

Hearing Name	SBA Investment Programs
Committee	Full Committee
Date	6/21/2007

Opening Statement of Ranking Member Chabot

I would like to thank the Chairwoman for holding this important hearing on programs designed to increase equity investment in small businesses.

Small businesses may finance their operations through debt or equity. Debt's primary benefit is that the owners maintain control of the company but that comes at the cost of increased cash flow out of the company to service the debt. Equity investment reduces cash needed, especially in the early years of a business, but comes at the cost of reduced control by the owners.

Federal assistance to small businesses has come in the form of both debt and equity. Debt programs available through federal-private partnerships include the 7(a) guaranteed loan, Microloan, and Certified Development Company or CDC programs. Equity investment is available through the Small Business Investment Company and New Market Venture Capital programs.

The Committee already has addressed necessary changes in the 7(a) and CDC programs. Last week, the Committee held a hearing on the microloan program and will be addressing legislation on that issue soon.

It is now time for the Committee to turn its attention to the equity programs operated by the Small Business Administration. First and foremost, the Committee needs to understand the nature of equity investment in small businesses. Then, the Committee must consider the quality of existing programs that assist small businesses obtain equity investments. Finally, if those programs are inadequate, the Committee should consider changes to improve the efficacy of existing programs or eliminate them and create more cost-effective new ones.

For example, if the Committee finds that the largest equity investment in small businesses comes from the personal assets of the business owner, then Congress must adopt tax policies that ensure the business owner keeps those assets rather than return them to the Treasury in the form of taxes.

On the other hand, if significant equity investment in small businesses derives from investment firms, such as small business investment companies, the Committee certainly needs to make sure that the program meets its objectives without placing undue risk on the public treasury.

The review of equity investment programs also must examine where investment is lacking. I know the Chairwoman has been to my district and seen the need in certain areas to increase investment as a component of economic revitalization. I would like to work with all the members of the Committee in finding appropriate cost-effective incentives that will

raise the amount of equity investment in areas that have sorely lacked such investment.

Finally, I would like to thank the Chairwoman for examining the angel investment phenomenon. Although angel investors may be an appropriate savior for small business, it is difficult for many small business owners to find an angel investor. Congress may have the opportunity to reduce the costs of raising equity funds from angel investors by eliminating burdensome and multiplicative federal and state regulation.

Again, I would like to thank the Chairwoman for holding this hearing and look forward to the ideas offered by our distinguished panelists.

I yield back the balance of my time.

TESTIMONY OF
ASSOCIATE ADMINISTRATOR
MICHAEL HAGER
SMALL BUSINESS INVESTMENT PROGRAMS
COMMITTEE ON SMALL BUSINESS
US HOUSE OF REPRESENTATIVES
JUNE 21, 2007

Good Afternoon. My name is Michael Hager and I am the Associate Administrator for Capital Access at the US Small Business Administration (SBA). I want to thank you for the opportunity to testify on the status of the Small Business Investment Company programs at SBA. I apologize that the head of the SBA's Investment division, Jaime Guzman Fournier, is not able to be present. He recently departed federal service to pursue a new opportunity in California.

The past few years have been challenging for the SBIC program. Performance in the participating securities program experienced significant financial challenges over the past several years.

As a result of these financial challenges, the participating securities section of the program was effectively terminated after Fiscal Year 2004.

Current estimates continue to project likely losses of $2.4 billion dollars on the more than $8.5 billion participating securities guaranteed through Fiscal Year 2006.

As of May 2007, of the 140 participating securities SBICs licensed prior to Calendar Year 2001, seventy-two were transferred to the Office of Liquidations. Twenty-two SBICs have repaid the SBA their leverage, including six that were transferred. However, not all of the SBICs that repaid their leverage repaid their prioritized payments. Of the leverage transferred to the Office of Liquidation, 51% was drawn by SBICs that began investing between 1994 and 1998.

Since the end of FY 2006, the Investment Division has taken significant steps and devoted the majority of management time for the SBIC program to managing the risk of the remaining participating securities portfolio. For example, we have recently revised the SOP for the Office of SBIC Operations. The SOP addresses such issues as approving leverage draws, placing funds into Restricted Operations and the transfer of funds to liquidation. These processes have all been updated to reflect our recent experience with the participating securities program.

I am happy to report that with these solid management steps and the improved economic conditions, the current portfolio of participating securities licensees has stabilized. While some additional losses are still predicted to occur, the majority of liquidations have been recorded. In fact, distribution activity among participating securities licensees has

been robust the last 8 quarters (August 2005 through May 2007), and the SBA and bond holders received distributions of almost $1.5 billion. In comparison, during the preceding 8 quarters (August 2003 through May 2005), the SBA and bond holders received only $563.7 million. The number and dollar amount of leverage being transferred to liquidations is down.

For example, in December, SBA issued a revised policy outlining how a capitally impaired SBIC can emerge from restricted operations to resume normal investment activities. This is not an automatic reinstatement process but SBA will work with licensees to help them get back on track.

In the debenture program, SBA continues to see solid performance from our licensees and is also now beginning to see renewed interest in the SBIC debenture product. The debenture program has established a history over forty years of significant performance as part of the Nation's economy and has operated without cost to the taxpayer, aside from administrative expenses, for the last seven years. In 2006, SBA guaranteed over $400 million in SBIC debentures and we anticipate exceeding that level this year. In the debenture program SBA has also been focused on making capital increasingly available to small business in low and moderate income (LMI) areas. Currently, approximately 20% of debenture funding goes to LMI areas.

Additionally, in our efforts to address underserved markets, the New Markets Venture Capital program (NMVC) continues to foster economic

development in Low Income (LI) areas through equity investing and no-cost technical assistance. This program, based on the SBIC program, is unique in that the fund managers of NMVC Companies (NMVCCs) receive grant funding to provide operational assistance to actual and/or potential portfolio companies to reduce the risk of investing in these nontraditional areas. The program is also unique, because NMVCCs are not licensed by SBA but rather approved through individual contractual agreements – or Participation Agreements – with the Agency.

The six NMVCCs participating in the program provide access to patient capital and foster entrepreneurial development in the underserved areas across fifteen states and the District of Columbia.

To date, NMVCCs have made over $40 million in equity investments in over 50 portfolio companies, creating over 400 new jobs in addition to approximately 1,100 jobs retained. NMVCCs also provided over $10 million in no-cost operational assistance to over 170 actual and/or potential portfolio companies in their targeted geographic areas. While these initial results are promising, it would be premature to judge the program's overall effectiveness as the six NMVCCs are only part way into the "investing" stage of their investment plans. Not until the NMVCCs have completed the "harvesting" stage of their life cycles can SBA adequately judge the individual performance of each NMVCC and the overall performance of the NMVC program.

The Agency is working diligently to strengthen its relationship with the industry. We have re-instituted quarterly meetings with industry leadership to address issues and concerns and work toward common

solutions. I believe these meetings have been productive. The SBA is actively seeking industry input on making the SBIC program more attractive to both venture fund managers and investors. We continue to believe the debenture program can have a substantial positive impact on the communities where SBICs invest and we want to ensure the program is positioned to maximize that impact. We look forward to working with all stakeholders to make this happen.

Thank you for the opportunity to testify before the Committee today and I look forward to any questions the Committee Members might wish to ask.

Testimony of Josh Lerner

Committee on Small Business
U.S. House of Representatives

June 21, 2007

Thank you for the invitation to testify today as part of the review of the Small Business Administration's investment programs.

My name is Josh Lerner. I am the Jacob H. Schiff Professor of Investment Banking at Harvard Business School, with a joint appointment in the Finance and the Entrepreneurial Management Areas. Much of my research focuses on the structure and role of venture capital and private equity organizations. In the 1993-94 academic year, I introduced an elective course for second-year MBAs on private equity finance. In recent years, "Venture Capital and Private Equity" has consistently been one of the largest elective courses at Harvard Business School. I have written over twenty-five academic articles and fifty cases on venture capital, which is collected in the books, *The Venture Capital Cycle*, *The Money of Invention*, and *Venture Capital and Private Equity: A Casebook.* I founded, raised funding for, and organize two groups at the National Bureau of Economic Research—Entrepreneurship and Innovation Policy and the Economy—and serve as co-editor of their publication, *Innovation Policy and the Economy.*

In my testimony today, I will emphasize two points:

- Venture capital can play a powerful role in encouraging innovation and economic growth: academic work suggests that one dollar of venture investment is as powerful as three dollars in simulating innovation.
- It is natural to believe that government programs can boost venture activity. But these efforts must be careful designed to work with and listen to the private venture capital market dictates and to embody thoughtful evaluation of the programs.

Before considering how venture capitalists boost innovation, it is worth highlighting how the challenges associated with the financing of young firms. Young firms, particularly those in high-technology industries, are often characterized by considerable uncertainty and informational gaps that make the selection of appropriate investments difficult and permit opportunistic behavior by entrepreneurs after financing is received.

Financial economists argue that specialized financial intermediaries, such as venture capital organizations, can address these problems. By intensively scrutinizing firms before providing capital and then monitoring them afterwards, they can alleviate some of the information gaps and reduce capital constraints.

To address these information problems, venture investors employ a variety of mechanisms. First, business plans are intensively scrutinized: of those firms that submit business plans to venture organizations, historically only 1% have been funded. The

decision to invest is frequently made conditional on the identification of a syndication partner who agrees that this is an attractive investment. Once the decision to invest is made, venture capitalists frequently disburse funds in stages. Managers of these venture-backed firms are forced to return repeatedly to their financiers for additional capital, in order to ensure that the money is not squandered on unprofitable projects. In addition, venture capitalists intensively monitor managers. These investors demand preferred stock with numerous restrictive covenants and representation on the board of directors. Thus, it is not surprising that venture capital has emerged as the dominant form of equity financing in the U.S. for privately held high-technology businesses.

Looking at the question of the impact of venture capital on innovation is a challenging one. While one can look association of venture capital funding and various measures of innovation, the interpretations of these analyses can be flawed: both venture funding and innovation could be positively related to the arrival of technological opportunities. Thus, there could be more innovation at times that there was more venture capital, not because the venture capital caused the innovation, but rather because the venture capitalists reacted to some fundamental scientific discovery. To cite another example, if we observe many personal injury lawyers at the scene of traffic accidents, it does not mean that the lawyers *caused* the accidents.

In work that Sam Kortum and I have done, we addressed these concerns using a variety of statistical approaches. Even after addressing these causality concerns, venture funding has a strong positive impact on innovation. The estimated coefficients vary

according to the techniques employed, but on average a dollar of venture capital appears to be three to four times more potent in stimulating patenting than a dollar of traditional corporate R&D. The estimates therefore suggest that venture capital, even though it averaged less than three percent of corporate R&D from 1983 to 1992, is responsible for a much greater share—about ten percent—of U.S. industrial innovations in this decade. Since innovation is closely linked to economic growth, this is vitally important.

At the same time, the impact of venture capital on innovation does not appear to be uniform. In many instances, the levels of venture funding in promising technologies appear to "undershoot" the desired levels. During these troughs, promising companies may not be able to get funding, no matter how promising the idea. Whether caused by misleading public market signals or pessimism on the part of the venture capitalists, funds appear not always to be deployed in the most efficient manner. Moreover, venture funding is highly geographically concentrated in a few regions.

Given these patterns, it is natural to view government funding as a potential solution. The characteristics of venture capital markets lead to there being a natural government role in encouraging their evolution. Venture capital is a business where there are increasing returns: put another way, it is far easier being a venture capitalist if there are ten other investors nearby than if one is alone. In many respects, venture capitalists benefit from their peers. For instance, if venture capitalists are already active in the market, institutional investors, entrepreneurs, intermediaries such as lawyers, data providers, and the wider capital markets are likely to be knowledgeable about the venture

capital process and what it requires in terms of financing, support and exit mechanisms. In the language of economics, venture capital is an activity where the actions of any one group are likely to have positive "externalities" for its peers.

It is in these types of settings where the government can often play a very positive role as a catalyst. The Small Business Investment Company (SBIC) program in the United States led to the formation of the infrastructure for much of the modern venture capital industry. Similarly, public programs played an important role in triggering the explosive growth of the Israeli and Singaporean venture market. Because of the "increasing returns" nature of venture capital, these efforts can play an important role in the industry's early days.

At the same time, governments must avoid the common pitfalls that befall public venture initiatives. One common failing is to ignore the realities of the venture capital process. For instance, many public venture capital initiatives have been abandoned after a few years: the programs' authors have apparently not understood that these initiatives take many years to initiate. Others have added requirements—such as the stipulation that portfolio companies focus only on explicitly "pre-commercial" research—that while seemingly reasonable from a public policy perspective, run counter to the nature of the venture capital process. In other cases, reasonable programs have been undermined by other poorly considered initiatives sponsored elsewhere by government.

A closely related problem is the creation of programs that ignore the market's dictates. Far too often, government officials have sought to encourage funding in industries or geographic regions where private interest simply was not there. Whether driven by political considerations or hubris, the result has been wasted resources. Effective programs, such as the Israeli Yozma program, address this problem by demanding that credible private sector players provide matching funds. Thus, when encouraging new venture funds under the New Markets program, it will be important to insure—whether through matching fund requirements or other means—that these new funds are viable ones.

Another pitfall is the failure to design appropriate evaluative mechanisms. Ideally, programs will undergo careful scrutiny at two levels. First, each program will be carefully analyzed. While recognizing that any initiative will take time to bear fruit, it is important to periodically take stock as to what aspects appear to be working well and which are problematic. Second, fund managers and firms participating in the programs should be scrutinized. It is important to ensure that the groups benefiting from these programs are the most promising in the industry in terms of market performance and can benefit the most from public investment, rather than simply those most adept at garnering public funds. Again, this will be an important element to incorporate.

Thank you for this chance to testify.

TESTIMONY OF
JOHN MAY
CHAIRMAN
ANGEL CAPITAL ASSOCIATION

HOUSE COMMITTEE ON SMALL BUSINESS
U. S. HOUSE OF REPRESENTATIVES

JUNE 21, 2007

Chairwoman Velázquez, ranking member Chabot, and all the other members on the committee, thank you for holding this hearing on investment programs at the Small Business Administration and for inviting me to participate. It is a pleasure to represent the growing community of sophisticated, pro-active private investors known as "angel" investors in the United States.

Angel Capital Association

I am this year's Chairman of the newly formed Angel Capital Association, the professional alliance of angel groups in North America. We represent over 130 structured angel groups of accredited investors ranging in size from 10 to 270 investors located throughout urban and rural United States and Canada. Our member organizations represent over 5,600 high net-worth investors who provide their time and investment resources to emerging growth companies in all sectors and regions of the country. Our investors are what we call "mentor capitalists" who give back to the entrepreneurial economy by making high risk equity investments in generally early-stage companies and providing value added services in the hope of generating long term capital gains and sustainable businesses in the communities in which they live. I am also co-founder of New Vantage Group, a Vienna, VA firm that organizes and manages four angel investor networks comprising over 270 men and women private investors in the mid-Atlantic region.

Early-stage private equity capital for high growth companies in the U.S.

The engine of job growth and technological innovation in the United States comes from small business people and entrepreneurs. We focus on the high growth, high-risk entrepreneurial sub-set of the millions of small businesses in the United States. We believe that our economy needs more of these high potential ventures. Study after study has shown the benefit of the entrepreneurial economy, and it is well known that almost all Fortune 500 companies had their start with one founding entrepreneur or a small group of innovators.

History of angel investing and current environment

Angels are basically defined in today's literature as high net-worth individuals who invest their own dollars in early-stage, high-growth companies primarily within their own region. They invest for significant financial, as well as psychological return. They become angel investors "for a variety of reasons including achievement of financial return, to support their community, to create and grow companies, to find a new job, to learn new things, to make use of their expertise, and for personal enjoyment."[1] They invest individually, in ad hoc groups, and more recently, in structured angel groups that meet monthly and co-invest with each other.

The Ewing Marion Kauffman Foundation of Kansas City, MO has been a strong sponsor of research into and education for this sophisticated end of the angel investor marketplace. Their research points to an equity capital gap for emerging growth entrepreneurs that can be most effectively addressed through non-traditional means – angel investors. Under Foundation President Carl Schramm, they have championed the programs which have evolved into the Angel Capital Association and the Angel Capital Education Foundation.

The widening early-stage capital gap and how national policy can address this crisis

One academic researcher puts the size of the informal, angel market at roughly the same size as the entire U.S. institutional Venture Capital ("VC") market - $25.6 billion, up ten percent from

[1] Scott Shane, Professor of Economics, Case Western Reserve University, *Angel Investor, A Study of Angel Groups for Five Federal Reserve Region*, 2006.

the prior year.[2] By comparison, in a 2006 MoneyTree Survey, published by Pricewaterhouse Coopers/NVCA, Thompson Financial stated that institutional venture capital firms invested $26.1 billion into 3,416 companies. There are, however, remarkable differences between the two investor groups. Angels by definition risk their own personal capital, not "other people's money" like VC's. They enter into about 50,000 transactions per year, versus the VC count of 3,416. Fifty percent of VC transactions are concentrated in California and New England. Surprisingly, 26 states last year received only one or no VC deals. Conversely, angel investors operate throughout the entire country. Furthermore, less than 1,000 of those 3,416 institutional transactions reported last year by VC's targeted seed and early-stage rounds of finance, whereas a majority of the angel and angel group investments were placed at that stage, according to a report by the University of New Hampshire.

We can see that angel investing is the "original venture capital" and continues to support far more start-ups in pre-profitable, potentially high growth companies in the U.S. than the banking industry or the institutional VC asset class.

Areas where the SBA could help early-stage entrepreneurs and angel investors

1. Education, readiness, awareness training

It is important to provide awareness training and seminars for entrepreneurs thinking of raising outside capital from angels or venture capitalists. In addition, readiness-training programs in the U.S., such as the Kauffman Foundation's Power of Angel Investing, and in Europe, such as the EU backed European Business Angel Network, have proven critical in providing the necessary tools for new and established investors, universities and professionals to provide support and mentoring in best practices and techniques for funding early-stage companies. An opportunity exists for the SBA to sponsor or subsidize educational initiatives to underserved or first time entrepreneurs through third party providers. An effort to smooth the search and negotiation process between entrepreneur and angel investor would be money well spent.

[2] Jeffrey Sohl, Director, Center for Venture Research, University of New Hampshire, *The Angel Investor Market in 2006: The Angel Market Continues Steady Growth*, 2006.

2. Infrastructure and development support for angel groups

Recent studies confirm that about five to six percent of high net-worth individuals in the U.S. currently provide angel capital and support.[3] We need to find ways to dramatically increase this resource for domestic entrepreneurs. A non-profit, educational organization or government agency cannot be a for-profit, lead investor and provide hands-on, patient capital through private equity groups. They can instead be the regional supporters through research, studies, and underwriting the creation of new angel groups. It is in this capacity that the SBA can have an impact on the angel and start-up industries. The SBA can serve as a provider of organizational grants for groups in formation that need education, on-line infrastructure, and other framework support to encourage the launch of structured angel groups in local communities. This might be provided through existing SBDC's or the SCORE program infrastructure with new resources and direction. These organizations can leverage people with experience in raising capital and making early-stage equity investments and be well-positioned to support the development of active and effective angel groups.

3. Federal tax credit program opportunities

Several foreign countries (UK and France, for example) and 21 states in the U.S. have instituted or experimented with direct tax relief – credits or waiver of capital gains taxes or both – to spur increased risk capital in small business start-ups. These credits are generally offsets against other investor taxable income and help lower the exposure angels face when investing time and money in high-growth, high-risk opportunities in their neighborhoods. We recommend the study of alternative fiscal relief initiatives at the federal level that would spur new investor participation. The SBA might take the lead in directing much needed dollars into innovative companies, minority and women led small businesses, and new businesses starting in underserved areas. Remember, over 50 percent of U.S. institutional venture capital now goes into only two states – California and Massachusetts. We at the Angel Capital Association know first-hand from reports of our investor members that thousands of deserving high growth companies are located in the other 48 states and the District of Columbia.

[3] Prince and Associates, 2007.

4. Leveraging private investments

If simple, non-bureaucratic techniques of directing SBA investment funds – similar to the SBIC or New Markets Growth fund approaches – could be developed to co-invest with angel group investments, entrepreneurs could have a more efficient market for fund raising. Several groups, such as the Ohio Tech Angels (who have a co-investment $2.5 million fund raised from The Ohio State University, Nationwide Insurance and the State of Ohio) and Common-Angels in Boston (which has raised a $10.0 million co-investment fund from private sources in their region) have successfully developed innovative "side car" funds to leverage dollars invested into entrepreneurs in their region on the personal investment decisions of members of their angel groups. Scotland pioneered a government fund that automatically co-invests with qualified accredited investor groups to spur economic development and growth of high impact companies at a low overhead and bureaucratic cost. We urge you to consider such an innovative approach for American entrepreneurs.

5. Accredited investor standards and impact on high growth company investing

Beyond the SBA reauthorization particulars, two other fundamentals of early-stage venture capital infrastructure should be noted and preserved. Maintaining the definition of sophisticated investors – "accredited" by the definition provided in securities law - will allow angels of all types to continue to participate in our venture capital system. Abruptly increasing the threshold of net-worth above the current $1.0 million – for this particular asset class activity – could have potentially detrimental impact on seed stage funding in the U.S. In addition, changing the current long term capital gains rates or taxation method for carried interest by managers of venture (or angel investor) funds could have a chilling effect on capital formation for American entrepreneurs. We need a robust institutional venture capital industry to help us grow our highest potential companies. Care should be taken not to address issues that exist in one part of the private equity world and render harm to the early-stage portion of that world.

Summary and final thoughts

Once again we wish to thank you for this opportunity to describe the role and impact of angel investors in our economy and to provide some thoughts on how the SBA can work with entrepreneurs and their angel investing backers to grow more high impact companies in our economy in the coming years.

NASBIC
America's Small Business Partners

Statement
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Before The

United States House of Representatives
Committee on Small Business

Regarding

Legislative Proposals
for
The SBIC Program

June 21, 2007

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Chairman Velázquez, Ranking Member Chabot, and members of the Committee:

Thank you for inviting me to testify today on behalf of the National Association of Small Business Investment Companies regarding our proposed legislative changes for the SBIC program.

By way of introduction, I am a partner with Prism Capital, a team of six professionals managing two SBICs: Prism Opportunity Fund, a Participating Security SBIC licensed in 1999, and Prism Mezzanine Fund, a Debenture SBIC licensed in 2003. As I indicated at the Committee's budget hearing in April, we have a combined total of approximately $195 million under management in the two funds. Our main office is in Chicago, Illinois. We have satellite offices in Seattle, Washington; Englewood, New Jersey; Minneapolis, Minnesota; and Milwaukee, Wisconsin. I am also NASBIC's Chairman-Elect, scheduled to assume that position in October.

At Prism we invest in growing industrial companies located in the Midwest, providing capital and strategic advice for internal growth, recapitalizations, mergers, acquisitions, and ownership changes. Our Advisory Board members have decades of executive experience and have successfully navigated the full spectrum of market conditions through their careers. They provide strategic insight and function as a management consultant to both our funds and our portfolio companies. Their invaluable insights and industry affiliations create tactical advantages and opportunities typically not available to this market. Our goal is to provide all of the financial and advisory resources necessary for our portfolio companies' success.

We are committed to backing exceptional entrepreneurs who have the vision, drive, talent, and business models to be leaders within their industries. We understand that growing an exceptional business is a lengthy, complex process that more often than not includes many unexpected developments along the way. Thus, we are a patient investor, investing with a horizon of between three and seven years depending on the requirements of the small businesses we invest in. We also invest with the mindset that growth requires additional capital and reserve for follow-on investments. We maintain an extensive network of contacts in the private equity community and can assist small companies by bringing additional investors into a transaction.

Turning to the purpose of my appearance here today, I would like to start with some brief background points. The SBIC program is made up of three parts:

1. **The Debenture program.** The Debenture program has been in operation since the start of the SBIC program in 1958. Since 1994 its purpose has been almost exclusively to promote debt financing (generally subordinated debt) of U.S. small businesses. The program is very simple in conception: Debenture SBICs borrow money over time at low government-guaranteed interest rates (with SBA as the guarantor) to augment their private capital (the minimum required is $5.0 million) by a ratio that generally does not exceed 2:1. The private capital and borrowed money is then available to invest in small businesses at higher rates of return (with SBA setting the maximum rates of interest that can be charged). The money borrowed by SBICs is repayable in a lump sum at the close of 10 years (the general case, although it can be repaid earlier), but interest is payable semiannually. There are currently 135 Debenture SBICs managing $5.8 billion in committed capital resources.

2. **The Bank-owned SBIC program.** Prior to the passage of the Gramm-Leach-Bliley Act (GLB) in 1999 the only way a bank could operate a venture capital or private equity fund was by obtaining an SBIC license. This led to the creation of many large bank-owned SBICs (e.g., Chase Capital Partners) that did not use government-guaranteed funds to augment their capital (they could use their own depositors' capital at less cost), but still invested (as required by law) in SBIC program target U.S. small businesses. However, with the passage of GLB, banks are now permitted to operate private equity subsidiaries without the necessity of obtaining SBIC licenses. As a result, less than 5% of dollars now invested by all SBICs is attributable to bank-owned and operated SBICs. Some banks continue to invest funds in Debenture SBICs (generally for CRA credit), but the era of big bank-owned and operated SBICs is over. There are currently 58 bank-owned and operated SBICs managing $1.9 billion in committed capital resources.

3. **The Participating Security program.** The Participating Security program is the newest of the SBIC programs, but it is ramping down out of existence. The program was designed to promote equity investments in small companies. Started in FY 1994, it was the fastest growing of the SBIC programs through FY 2004. At that point the government stopped issuing Participating Security licenses because it was determined there was no way to continue the program as a credit subsidy program and appropriating leverage on a dollar-for-dollar basis was seen as impossible given the total dollars involved. The last government-guaranteed Participating Security leverage available will expire September 30, 2008. That unfortunate fact will leave most of the 167 remaining PS SBICs with no way to complete the business plans that had been approved by SBA in the licensing process, and many of these funds had projected to be in business through 2014.

With that background, NASBIC has submitted three legislative proposals for your consideration. The proposals are in keeping with our primary goal for the year: to improve the general view of the SBIC program among private sector capital managers and investors who might be inclined to participate in the SBIC program. Many of these individuals and institutions have been reluctant to participate because of negative publicity related to the government's decision to cut monetary support for the Participating Security program after September 30, 2008. That decision is considered unreasonable by the private sector and is contrary to legitimate expectations that can be found in the SBA-approved business plans of Participating Security SBICs that will be in business and in need of capital for several years after that date.

However, we must deal with the situation as we find it and we are pursuing our goal on two fronts. First, we have been working with SBA to improve the working relationship between SBA and the SBICs it regulates. This includes working together to find changes that might be made to SBA-promulgated regulations to eliminate unnecessary work or expense on both sides and to better align the regulations, where possible, with business norms in the private equity industry of which the SBIC program is a part. Examples of our collaboration include elimination of Debenture pre-payment penalties, changes in the calculation of management fees, elimination of time and expense related to what have been identified as unnecessary SBA pre-investment approvals, and a pending request that SBA change its current interest rate ceilings to better reflect market reality.

Our second and no less important effort relates to legislation to be considered by this Committee. In making the proposal I will discuss shortly, we decided to focus only on those issues that we believe fit within our overall goal. The proposals are not revolutionary in nature. The first two proposals are incremental changes that will simplify and improve the Debenture SBIC program. The third proposal is one last attempt to find a way to improve the lot of Participating Security SBICs that will suffer lack of investment capital following September 30, 2008, through no fault of their own.

A discussion of our specific proposals follows. I will not speak to suggested legislative language that we have already discussed with Committee staff. Rather, I will address the proposals in layman's terms that I believe will make them easier to understand.

1. **Rationalize the law concerning the maximum amount an SBIC can invest in any one portfolio company.**

   In this case I use the word rationalize in accordance with its primary definition: "to make rational."

   a. Currently, §306(a) of the Small Business Investment Act provides that no leveraged SBIC may invest more than 20% of its private capital in any one portfolio company without appealing for an exception to the Administrator. The intention of the limitation is to ensure that leveraged SBICs have diversified portfolios, thus mitigating investment risk for both private investors and the government.

   b. The problem with current law is that different leveraged SBICs plan for different ratios of leverage to private capital in their business plans approved by SBA in the licensing process. The projected ratios most often approved in the licensing process are between 1:1 and 2:1 even though the SBIA provides for as much as 3:1 in some cases. The application of a maximum investment amount based on a percentage of private capital versus a percentage of total capital to be managed by an SBIC produces inconsistent results unrelated to risk.

   c. For example, an SBIC licensed with an SBA approved business plan projecting 1:1 leverage would be allowed to invest 10% of its total projected capital—20% of private capital equals 10% of total planned capital at a 1:1 leverage ratio—in a single small business. An SBIC with an approved ratio of 2:1 would only be able to invest a maximum of 6.67% of its total capital in one small business. This inconsistency has nothing to do with risk management. All that it accomplishes, in strict application of the formula, is to force those SBICs that make use of two tiers of leverage to invest in 50% more companies than funds using one tier of leverage. The result is less capital available for any one small business; an inability to invest more capital in successful businesses to increase SBIC returns; and, at least as important, an SBIC management team that may be spread too thin to allocate adequate time to individual portfolio companies to help them achieve their growth goals. Time spent by SBIC professionals working on behalf of the companies they invest in is often called as valuable as or more so than the actual SBIC dollars invested in the company.

d. In summary, the current rule has no rational base, is counter to industry practice, and is a disincentive for many management teams that might otherwise consider applying for SBIC licensees.

To address this problem, NASBIC proposes that the current effective limitation of 10% of total capital for a fund using a 1:1 leverage ratio become the standard for SBICs at any leverage ratio. Instead of calculating the limit by reference only to private capital, the 10% investment limit would be calculated by reference to total capital (including leverage) projected by each SBIC in its business plan approved by SBA in the licensing process or as projected in any subsequent SBA-approved change to that business plan. This change in the law would apply a general portfolio management rule ("no more than 10% of capital should be invested in any one company") that is an accepted norm in the non-SBIC industry and would ensure that SBIC management teams have both the financial and time resources required to help their portfolio companies achieve their growth goals.

2. Adjust and simplify the laws related to the maximum leverage available to an SBIC

The following are NASBIC's observations on the laws related to the maximum leverage available to an SBIC or group of co-managed SBICs:

a. The maximum leverage cap for FY 2007 is $127.2 million for any one SBIC or for multiple SBICs controlled by the same management team. The cap increases automatically annually by the percentage increase in the Consumer Price Index (CPI).

b. The SBIC program benefits if successful SBIC management teams elect to remain in the program by securing additional SBIC licenses supported by new private capital when the primary investment periods of previous funds close. At that point the management team must raise another fund to secure an uninterrupted source of capital for making new investments. Often the "old" fund is winding down (with capital being returned to the SBIC through investment realizations) at the same time new investments are being made by the "new" fund.

c. The fact that the leverage cap applies to the whole family of funds can make it impossible for a large successful SBIC to operate a second or third fund due to lack of available leverage because of the leverage cap, not because of any increased risk to SBA based on poor financial performance. If that is the case the management team must raise a non-SBIC fund rather than stay in the program. Once that occurs the likelihood of that management team returning to the SBIC program is very small. We estimate there are at least eight Debenture SBICs that might be negatively impacted by current limits if they were to form another SBIC.

d. The maximum leverage problem related to multiple funds can be solved by making "transition" leverage available.

e. In addition, current law applies investment conditions on leverage above $90 million. For use of leverage up to $90 million, not less than 20% of investments must be in a subset of qualified small businesses defined as "smaller enterprises." Above that mark, 100% of investments made using leverage above $90 million must be in "smaller enterprises." As the leverage cap continues to grow the provision imposes additional "tracking" workloads on SBA and the impacted SBICs.

f. Finally, there are no special incentives related to leverage availability that might increase the number of SBICs that would focus on investments in women-owned and minority-owned small businesses.

To address all of the above points, NASBIC proposes that the law be changed as follows:

(1) Increase the leverage cap for any one fund to $150 million, but eliminate the annual CPI adjustment to that cap. This would give ample maximum leverage for several years and end automatic increases that might not be desirable under high inflation periods.

(2) Raise the leverage cap that applies to SBICs under the common control of one management team to $225 million. This change would allow second and third SBICs in compliance with SBA capital impairment regulations to naturally transition to investing out of the latest fund without having to "force" liquidations of investments in previous funds to "free up" leverage space.

(3) Provide an incentive that might lead to an increase in investments in minority- and women-owned small businesses by increasing the leverage caps in (1) and (2) above to $175 million and $250 million, respectively, for any SBIC that agrees that not less than 50% of its investments will be made in companies that, prior to the investment, are owned by either women or minorities or are located in a low-income geographic area.

(4) Change this percentage requirement related to investments in small enterprises to a flat 25% for all leveraged SBICs, regardless of whether they have more than $90 million in leverage.

The proposed changes will provide an incentive for successful SBIC management teams to remain in the program, simplify the laws related to maximum available leverage and how it is invested, and provide an economic incentive that may result in more capital being made available to small businesses owned by women and minorities. Incentives and simplicity will attract more management teams and investors to the SBIC program in the future.

3. Allow Participating Security SBICs to draw committed leverage faster.

a. Participating Security (PS) SBICs face a serious crisis. The only PS leverage available is that represented by commitments that expire at the latest by September 30, 2008.

b. At current investment rates PS SBICs will not be able to use all the PS leverage represented by their commitments before the expiration dates even though they will need

capital after the expiration dates to fund investments and operations through the ends of their fund lives. The last of the PS funds will operate through 2014 at a minimum.

c. SBA estimates that the amount of PS leverage not drawn prior to the expiration dates may be as much as $1.0 billion. Without access to that capital PS funds will be unable to support the small businesses in their portfolios which require follow-on investments to sustain growth and will be unable to retain management teams to manage the portfolios. Risk of loss to private investors and SBA will grow substantially.

d. Failure to solve this problem is seen by the private sector as a breach by the government of the implicit promise to provide leverage to fund SBA-approved business plans through the fund's life provided the fund is in regulatory compliance and not in capital impairment. That perception will have a negative impact on the Debenture program as well; dissuading many who might otherwise seek to form SBICs from doing so.

e. At present, when leverage is drawn it must be supported by paid-in private capital rather than valid and SBA-approved capital commitments by private investors. This means that at a 2:1 leverage plan, $1.0 of private capital must be drawn in to support $2.0 of leverage draw.

To address this problem NASBIC proposes that PS SBICs be permitted to draw leverage based on SBA-approved private investor capital commitments rather than paid-in capital. This would allow them to use more of the leverage represented by expiring commitments while still having private investor commitments available to fund investments and operations after the expiration dates. The private sector commitments would still represent equity supporting SBA-guaranteed leverage and would still be payable to SBA in the event that a fund ran afoul of the capital impairment regulations after a leverage draw. No leverage draw would be permitted the regulations if a fund were in capital impairment prior to the proposed draw. While not a complete solution to the problems facing PS SBICs, enacting the proposed amendment might solve a fair percentage of the problem and indicate a government attempt to solve a problem not attributable to any failure by SBICs that face it.

Thank you again for the opportunity to appear before the Committee today. I hope my testimony will help you as the Committee drafts 2007 legislation for the SBIC program.